

January 6, 2000

Mr. Joshua R. Hochberg
United States Department of Justice
Chief, Fraud Section
P.O. Box 28188
McPherson Square Station
Washington, DC 20038
(e-mail version sent to patrick.donley2@usdoj.gov)

RE: President Clinton's Consumer Fraud Initiatives Directives

Dear Mr. Hochberg:

The North American Securities Administrators Association, Inc. (NASAA)¹ appreciates the opportunity to participate in these initiatives that directly address our main role of protecting consumers against securities and financial fraud at the state level.

Our members, individual state securities administrators, have always stressed the importance of coordinating their regulatory efforts with their federal counterparts. We hope to continue to build upon this already strong relationship within the area of consumer fraud.

INTRODUCTION

In the United States, NASAA is an organization of state securities commissioners and is dedicated to assisting the public with their investing concerns. Though NASAA itself has no regulatory authority, we coordinate our efforts with our members, the Self Regulating Organizations (SRO's) and other federal agencies.

It is important to note that the sale of securities in the United States is regulated on both the federal and state levels. On the federal level the primary regulatory agency is the Securities and Exchange Commission (SEC), with the National Association of Securities Dealers (NASD) as the primary self-regulatory organization (SRO).

¹ The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc. was organized in 1919. Its membership consists of securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots protection and efficient capital formation.

SIGNIFICANT CONSUMER FRAUDS

NASAA continually surveys and communicates with its members to understand and recognize the extent of consumer fraud occurring on the state level. Many of the NASAA sponsored task forces and project groups are specifically dedicated to a specific or general area of securities fraud.

Predicated upon our experience in the area of securities fraud, our submission will address five areas that we believe are topical, ubiquitous among our members and have the greatest impact on the individual investor. These areas are prime bank note fraud, internet investment scams, promissory note fraud, affinity fraud and business opportunity (franchise) fraud.

PRIME BANK INSTRUMENT FRAUD

A. The Problem

During the decade of the 1990s securities regulators and other enforcement agencies identified an insidious fraud, commonly known as “prime bank instrument” (“PBI”) fraud. PBI fraud is international in scope, and based on the misrepresentation that excessive profits may be earned from investing, with no risk of loss, in the trading of discounted debt instruments purportedly issued by “prime” European or world banks. In just two cases involving interstate and international activities, investigators estimate that con artists have collected over \$80 million.

The promoters of PBI fraud schemes have evaded conventional law enforcement techniques, because of their manner of operation. PBI programs usually operate like multi-level "pyramid" schemes, creating “downline” operations that recruit investors with the deceptive promise that they earn additional profits from investors they recruit. Since prime bank instruments do not exist, PBI programs are also “Ponzi” schemes whose “profits,” if any, rely on the recycling of investors’ funds. In fact, most investor money disappears offshore through wire transfers. When the loss of funds becomes apparent, program participants at all levels claim that they themselves were duped and defrauded by others.

B. Attempted Solutions

Securities regulators have used conventional investigative methods, such as subpoenas for records and testimony under oath, but the use of such techniques often allow the program organizers to conceal records and move funds offshore. When that happens, the investigation becomes merely a post-mortem reconstruction of the scheme and how the investors lost their money. By the time administrative cease and desist orders, civil injunctions, and judgments for restitution are entered, recovery of funds becomes nearly impossible.

C. Lessons Learned and Implemented

Experience teaches that PBI schemes may be contained only while investors are still being recruited and funds have not yet been laundered offshore. Because program organizers can wire transfer investor funds offshore on a moment's notice, it is incumbent to detect these programs early. More aggressive techniques, such as search warrants and seizure orders to sequester investor funds, will be need to deter these schemes.

Most PBI schemes are multi-state or even international in scope. Local participants and recruiters represent a small part of a larger network operating from one or more locations in other states. Identifying and tracking the larger networks requires manpower and information resources that exceed the ability of local investigators. Although ad hoc relationships among state and federal agencies have been formed to work a case, these temporary alliances depend on personal relationships that are subject to personnel turnover.

Under federal and state laws, such as in Arizona statute, A.R.S. § 13-2317, money laundering is a criminal offense that allows enforcement agencies to use new approaches to combating investment fraud. For example, in Arizona money laundering is a predicate offense under the state "RICO" statute. This statute prohibits a person from transferring the proceeds of "racketeering" while "knowing or having reason to know that they are the proceeds of an offense." Racketeering is generally involves unlawful acts committed for financial gain, which includes the fraudulent and unregistered sales of non-exempt securities.

Persons, therefore, commit the crime of money laundering by transferring the proceeds from the sale of unregistered securities, if the person transfers such funds knowing or having reason to know that the proceeds were obtained illegally. In states, such as Arizona, money laundering and securities violations trigger such extraordinary remedies as forfeiture. By employing the remedies available under RICO statutes, law enforcement agencies can, therefore, take away the incentives for violating investor protection laws by seizing the proceeds of unlawful activities.

D. Existing Inter-Agency Coordination

To combat PBI schemes more effectively, in Arizona, the securities regulator, the Arizona Corporation Commission-Securities Division, has aligned itself with other enforcement agencies. Having joined with its state Attorney General and an inter-agency task force, in employing RICO remedies, the Securities Division has enhanced enforcement of the state securities act. The inter-agency coordination means that action can be taken against fraudulent securities transactions that involve money laundering. As a result of the inter-agency coordination, more of the investors' funds are being recovered.

E. Improved Coordination in the Future

Recognizing that the tried-and-true enforcement techniques were not working, the Arizona Corporation Commission agreed to join an inter-agency task force that consists of the Arizona Attorney General, the United States Customs Service, the Arizona Department of Public Safety, the Federal Bureau of Investigation the U.S. Postal Inspection Service, and a District Office of the United States Securities and Exchange Commission. The money laundering element of PBI fraud allows closer cooperation with federal agencies such as the United States Customs Service, which has the jurisdiction and capability to conduct investigations across the United States and even offshore. Proof of money laundering also provides access to RICO remedies available through the Arizona Attorney General's office. Finally, money laundering also allows the task force to supplement agency resources with funds from the Anti-Racketeering Revolving Fund administered by the Arizona Attorney General's office. These funds have been used for travel expenses, obtaining documents, and creating digital databases.

Because PBI fraud is a form of securities fraud, the securities regulator provides crucial expertise and resources, involving intelligence gathering, financial investigation and forensic accounting. The offense of unregistered securities sales, which also is a RICO offense, provides a predicate offense to justify the issuance of search and seizure warrants. Often, probable cause to believe that there is an unregistered securities offering may be easier to show than proof of fraud. Since every PBI scheme involves the sale of an unregistered security, this offense will provide the grounds for the special remedies required to stop such sales.

F. Additional Suggestions

The foregoing approach to PBI fraud contemplates a strategy of rapid search and seizure of records and funds. Because PBI fraud is undertaken and operated by loose networks of associates, seized records can provide leads that investigators can follow quickly to track suspects and funds. Where required by circumstances, seized funds can be passed to a court-appointed receiver who will identify investors, thereby freeing the investigative agencies to pursue the leads provided from seized records. Receivership costs can be paid from the recovered funds. Since these funds would otherwise have been lost to investors without their seizure and control by a receiver, it is reasonable to tax the cost of recovery against the funds themselves.

INVESTMENT SCAMS ON THE INTERNET

A. The Problem

NASAA has recognized the unique challenges that investors face when transacting securities business over the Internet. These concerns were expressed in testimony before the Senate Permanent Subcommittee on Investigations on “Securities Fraud on the Internet” & “On-Line Trading Issues” on March 23, 1999 by then NASAA president Peter C. Hildreth:²

Over the past decade, technology has revolutionized the securities markets. Today, any home equipped with a computer and modem is just a few keystrokes away from a wealth of instantly accessible research data and financial news. The Internet holds great promise for investors by disseminating information previously available to a relative privileged few on Wall Street and by dramatically lowering trading costs. Many investors have opted to make their own investment decisions, bypassing traditional methods of conducting business. Technology is changing the relationship between broker-dealer and customer.

The legitimate business opportunities for financial services on the Internet are unlimited. It is already used for direct offerings of securities through company web sites, electronic voting of proxies and on-line brokerage services. In 1997, NASAA acknowledged the Internet would greatly facilitate the ability of securities professional to disseminate information to prospective customers and clients. NASAA issued an Interpretive Order to provide guidance to broker-dealers, investment advisers, broker-dealer agents and investment adviser representatives who use the Internet to distribute information.

At the same time, however, the risks for fraud are great. With the click of a mouse, fraudsters can reach tens of thousands of people via e-mail literally for pennies. E-mail and web sites are more efficient and much cheaper than contacting unsuspecting investors the traditional way, through telephone boiler rooms. The Internet is a global borderless environment that offers instant access to tens of millions of people. Con artists can hide their identities through the use of fictitious names, multiple aliases, remailers and by using public venues with Internet access such as Internet coffee shops and libraries. Because the Internet is so cheap and easy to use and reaches so many people, any con artist not on the Net should be sued for malpractice.

NASAA members are concerned about unwary investors being taken for an Internet ride. States are seeing violations of state securities law on the Internet such as the offer and sale of unqualified securities; unlicensed broker-dealer and investment adviser activity; fraudulent offers and sales of securities; market manipulation; and insider trading.

² This testimony along with the testimony of Philip Rutledge, Deputy Chief Counsel, Pennsylvania Securities Commission, on “Securities Frauds on the Internet” and “Current Issues Concerning Online Trading” before the Senate Permanent Subcommittee on Investigations on March 23, 1999 are available online at the NASAA web site: www.nasaa.org.

B. State Initiatives - Attempted Solutions

Given the size and growth of the Internet, regulators can't police it alone – it is like expecting one precinct house to patrol all of New York City. It simply can't be done. State and local governments have limited resources and defined jurisdictional boundaries, which is why we have asked investors to become partners with us in the fight against securities fraud on the Internet. In October of 1998, NASAA created a new e-mail address for investors to report suspected Internet securities fraud. The address is cyberfraud@nasaa.org.

NASAA encourages investors to forward suspicious securities-related e-mail they receive and to include the state in which they live so the "spam" can be sent on to the appropriate state regulator. During 1998, over 4,700 unsolicited e-mail messages were sent by investors to the cyberfrudad@nasaa.org. So far NASAA has forwarded e-mail to regulators in 33 states, from Arizona to Wisconsin. Late last year, the messages were analyzed to detect trends. Approximately 40 percent of the e-mails were securities related, a similar percentage involved business opportunities; the rest included credit and loan pitches, gambling/casino web sites, herbal and other health treatments and "cures" and sex-related topics.

State securities regulators have been policing Internet based investment scams for years. One great advantage of state securities regulators is their authority to use an undercover operation to detect fraud on the Internet. A state agency can establish e-mail addresses to go "shopping" for fraudulent Internet solicitations to obtain information to pursue enforcement cases. At the beginning of 1998, NASAA's Internet Committee conducted a survey of all member jurisdictions and reported securities being offered in the following types of securities offerings as involving the most suspected investment frauds: ATM machines, prime bank schemes, internet gambling, advance fee schemes, oil and gas interests and entertainment ventures.

In 1994, The Missouri Securities Division and the New Jersey Bureau of Securities announced the first regulatory actions taken in the U.S. against on-line investment schemes. In Missouri, a stockbroker unlicensed to do business in the state used the Internet to tout his own services and make dubious claims for stocks not registered for sale in the state. The case in New Jersey amounted to a high-tech variation on the old pyramid scheme, which is barred under federal and state laws.

Texas issued its first Internet related order in March of 1996 against a woman using the Internet to raise funds for an illegal securities offering. The violations included selling unregistered securities without a securities sales license. Earlier this year Texas made its first criminal referral to a prosecutor of an alleged securities fraud over the Internet.

The Ohio Division of Securities has been on the leading edge of securities activity on the Internet. In September 1996, the Division became one of the first state securities agencies to establish a formal program to monitor the Internet for compliance with the Ohio securities laws. On-line securities offerings not in compliance with Ohio law are identified and listed on the Division's Internet homepage under the link "On-Line Securities Offerings that Ohio Residents Should Avoid."

In March of 1998, the New York Attorney General announced legal actions designed to raise consumer awareness of the law regarding illegal Internet pyramid schemes. The AG's Internet and Computer Unit worked with the Investor Protection and Securities Bureau and reached settlement agreements in 12 cases involving illegal pyramid schemes circulated on the Internet. Pyramid schemes are illegal under both New York's civil and criminal law so participants risk being prosecuted for a misdemeanor or felony offense, which could result in fines and possible imprisonment.

In June 1997, the California Commissioner of Corporations issued nine actions against Internet investment opportunities ranging from a floating condominium to a time machine. The actions ordered ten companies and 15 individuals offering investment opportunities on the Internet to comply with state securities requirements or stop offering their investment products in California.

California has one of the more active Internet Surveillance programs in the United States. The Department of Corporations has set up a dedicated Internet Compliance and Enforcement Unit consisting of two attorneys, one investigator and one examiner. In all, the California Department of Corporations has issued 39 Desist and Refrain Orders to a total of 158 subjects, has filed one civil injunctive action and obtained a preliminary injunction against 26 defendants, and has referred two cases for criminal prosecution.

In August 1998, the Illinois Securities Department and U.S. Postal Investigation Service conducted a joint investigation into an unregistered offering of securities. The investigation led to criminal mail fraud charges being brought by the United States Attorney for the Southern District of Illinois, Charles Grace, against Ronnie Joe Graham. Graham devised a scheme to defraud and obtain money from investors through the offer, sale and issuance of unregistered securities, in an amount in excess of \$750,000 by means of materially false and fraudulent pretenses, representations and promises.

The investigations and prosecutions led to Graham pleading guilty to one count of mail fraud by use of the Internet. He was sentenced to three years probation, which the first six months was home confinement, and ordered to pay restitution in the amount of \$55,000.

C. Inter Agency Cooperation

In August of 1998, NASAA joined federal regulators in a crackdown on entertainment-related securities fraud. Not surprising, the Internet figured prominently in several securities offerings state regulators acted against. Regulators in New York obtained a temporary restraining order and froze the assets of World Interactive Gaming Corp. of Bohemia, NY which used the Net to sell and promote stakes in an illegal Internet gambling company. South Dakota and Wisconsin took related actions. Regulators in Iowa ordered Denis M. Benson of Tustin, CA to stop selling unregistered securities in an on-line sports casino. Washington State ordered White Witch Doctor, Inc. of Florida to stop promoting sales of stock, via the Internet, to finance "Diamante" a movie based on company owner Dennis Alexander's "real life experience as a missionary and diamond smuggler."

NASAA and 30 state and provincial jurisdictions participated in the Internet Investment Opportunities Surf Day in November 1998 looking for suspicious or fraudulent investment opportunities. Also taking part in the surf day were regulators from the FTC, the CFTC, and the NASD. Over 400 web sites were surfed. They found that investors were being sought for both traditional and exotic investment opportunities such as viatical settlements, foreign currency, films and restaurants, Internet-related and "offshore" investments.

The vast majority of the securities-related e-mails NASAA analyzed during the "surf" promoted eight over-the-counter stocks. The e-mails invariably contained bullish, if not far-fetched predictions such as a restaurant chain whose revenues were projected to grow 300 percent for the 97-98 fiscal year. In another case, a web site promoting low-priced over the counter stocks claimed that "with 1.2 million visitors per day starting with the next few days, there's NO CHANCE the stocks can't rise!!!"

NASAA also has joined other federal, state and local law enforcers to announce 33 law enforcement actions against 67 defendants promoting Internet pyramid schemes. The sweep also included a two-day Internet "surf" to seek out sites that may be hosting illegal pyramid schemes. The FTC and state law enforcement offices have pledged to continue this sweep and will announce additional actions targeting Internet Pyramid schemes in upcoming months. My advice to the investing public is "Ask yourself – if it's such a great money-making idea, why is someone telling 100,000 of their closest friends about it on the Internet?" Never make a decision to buy or sell an investment product based solely on information you read on the Internet.

State securities regulators across the country have brought actions against suspected Internet frauds, including on-line casinos, pyramid schemes and supposed investments in "soon-to-be produced" motion pictures. Web sites, news groups, chat rooms and e-mail messages are increasingly being used to tout risky "microcap" stocks, which are a major concern of state regulators.

D. Additional Suggestions

There will never be enough regulators to keep the on-line world free from fraud and abuse. Even if the state securities regulators, the Securities and Exchange Commission ("SEC"), and the National Association of Securities Dealers - Regulation ("NASDR") all put aside their other tasks in a massive bid to shut down on-line investment scams, it is doubtful that fraud on the Internet could be stamped out altogether.

Investor education is the key to successful on-line investing. Individuals who venture on-line need to do so with caution. The good news is there are self-defense steps that small investors can take to fend off cyberfraud. We have included these tips in a simple brochure as well as on the poster before you today.

- Don't expect to get rich quick
- Don't assume that your on-line computer service polices its investment bulletin boards
- Don't buy thinly-traded, little known stocks strictly on the basis of on-line hype
- Don't act on the advice of a person who hides his or her identity
- Don't get suckered by claims about "inside information" including pending news releases, contract announcements and products
- Don't assume that just because someone says that they have checked something out that they have actually done so
- Call your state or provincial securities agency

The NASAA Board of Directors has also formed several Project Groups to deal with the issues you are addressing today. In November 1998, an Internet Enforcement Project Group was established to review Internet enforcement by state regulators; develop a comprehensive plan on how states can better police on the Internet; and work with other NASAA Project Groups to coordinate efforts and determine the best way to utilize available technology.

PROMISSORY NOTE FRAUD

A. The Problem

Promissory note fraud is an increasing problem around the country and is listed sixth on NASAA's "Top 10 Investment Scams." Fraudulent promissory notes are supposedly insured by real assets when in reality, they are backed only by a worthless promise to repay. Some of the notes are issued on behalf of companies that do not exist. Others are issued on behalf of legitimate companies, but are offered to small investors because banks and venture capitalists have refused to invest in the companies.

The investors in fraudulent promissory notes are often elderly, and are lured by the possibility of earning a much higher return on their investments.

Insurance agents are often involved in the sale of promissory notes. Unlike cold callers, the agents calling are often those who have sold insurance policies, or those who have a prior relationship with the individuals being solicited. This prior relationship provides the agent an element of trust. The investors are lured into a false sense of security because they receive a promissory note, and a “guarantee.” “Regulators estimate that about 1,000 insurance agents are part of a nationwide scam that involves selling worthless promissory notes and bilking elderly investors out of their retirement savings.”³

A NASAA Press Release dated July 19, 1999 provides the following information about how a promissory note scam might work. An insurance agent who sold a policy calls with an intriguing investment opportunity. The agent tells the individual, often a vulnerable investor, that a “well established” company is looking to expand its business and needs to raise capital. Instead of borrowing money from a traditional lender such as a bank, the company is offering investors an opportunity to purchase “promissory notes,” typically with a maturity of nine months and an annual interest rate between 12 and 18 percent far more than the investor could get elsewhere. Agents, probably looking for high commissions, pressure clients to “cash in” their life insurance policies and “roll” them into these notes. Insurance agents, however, are not the only ones selling these fraudulent promissory notes.

Part of the compliance problem stems from the wording of the Securities Act of 1933 and the Securities and Exchange Act of 1934. Many agents are under the impression that notes which mature in nine months or less are either not securities or are covered securities, thus not requiring registration of the notes or licensure of the salespeople in the states.

The states have consistently taken the position that all of these notes are securities for purposes of state law. Many states provide an exemption for short-term notes, but the exemption is limited to commercial grade paper. Nevertheless, even if there were an exemption from registration, this does not exempt the agents from licensure. In regards to federal law, Jennifer Basil contends in a recent article in the NASAA Enforcement Law Reporter titled Notes: The Nine Month Maturity Exception Under Federal Securities Law, that it was Congress’ purpose to except only prime commercial paper and not all short term notes.

B. Attempted Solutions

1. *Enforcement* – Many states have made promissory note fraud an enforcement priority. At the present time, most enforcement cases originate from consumer complaints. Furthermore, as public awareness of the problem increases, our ability to enforce will also increase.

³ This information was obtained from the web site: www.insure.com/promissory899.html.

2. *Education and Prevention* – NASAA and the states consider promissory note fraud to be a major problem. Through press releases, NASAA has attempted to increase public awareness of this problem. NASAA's press release titled, "Promises, promises: Investors warned about risky, fraudulent promissory notes," suggests the following tips:
 - Investors should check with their state securities regulator to confirm that the notes are properly registered or legally exempt. If this information cannot be verified, do not invest.
 - Agents selling "notes" are required to be licensed by the state and NASD. Investors can contact their state securities regulator or the NASD to learn about the agent's history.
 - Investors should be suspicious if the notes have a rate above market and mature within a year.

C. Lessons Learned and Implemented

1. NASAA and the states have worked to increase public awareness of the problem of promissory note fraud. However, it would also be helpful to work with insurance agents directly to inform them of the licensing requirements that exist for the sale of promissory notes. This would require cooperation from the insurance commissions.
2. There continues to be a great deal of misinformation about how promissory notes are treated under the securities laws. This information must be clarified.

D. Existing Interagency Cooperation

The states and the SEC has coordinated efforts to solve the promissory note fraud problem, but it is sometime difficult to get information from other federal agencies such as the FBI or the IRS. For the most part, each agency and state has been working independently. However, a task force has been created to improve this coordination. Twenty states including California, Colorado, Florida, Georgia, Indiana, Kentucky, Maryland, Mississippi, Nebraska, New York, North Carolina, North Dakota, Ohio, Pennsylvania, South Carolina, Texas, Utah, Virginia, Washington and Wisconsin are involved. The task force was created to share information and resources to defeat the problem of promissory note fraud. Each state involved sent a representative to a seminar where information was shared about companies and individuals involved in this type of fraud. Each seminar attendee was given copies of the promissory notes and other documents used in these frauds which will be helpful to aid in prosecution. In addition, the contacts from the various states and organizations can offer assistance where necessary. In an area where not much information is shared, the task force serves as an effective method of combining efforts to achieve a common goal.

E. Improved Coordination in the Future

1. The States involved in the Task Force are working on a process to improve coordination. It would be helpful to include more states and federal agencies as well.
2. It would be helpful for the SEC to take a more proactive approach to the nine month exception in the '34 Act. By doing so, they could clarify which types of notes require registration and licensing and which do not.

AFFINITY FRAUD

A. The Problem

Affinity fraud is the term used to describe investment schemes that are targeted at and take advantage of members of specific groups of individuals who have a common background. The targeted group may have a common race, religion, national origin, age group or business affiliation. Affinity fraud is unique in that it undercuts the usual warnings about investment schemes promoted by strangers and involves promoters who are known and trusted in the community.

In affinity fraud scams, the con-artists realize that investors who are members of a tight-knit group are less likely to venture outside the group when searching for investment opportunities. Affinity fraud con-artists know the targeted group's objectives, beliefs, and weaknesses and these scamsters customize their sales pitches accordingly. The investors trust members of their group, including the con-artist, because they feel a common bond. Consequently, these investors often fail to contact regulators to verify the legitimacy of a proposed investment opportunity. Investors refuse to believe that someone who is like them would defraud them. These investors hesitate to complain to authorities even if they suspect that they have been defrauded. Many investors refuse to file complaints because they believe this would amount to a betrayal of someone who had good intentions of investing their money.

Affinity fraud has recently been exposed in a number of religious denominations. Bible quoting con-artists have convinced thousands of people to invest and lose millions of dollars in fraudulent schemes. These con-artists claimed that investor funds would be used to further God's work. Some scamsters even claimed that they had special callings or visions from God that would surely result in profitability for the investors. In all of the cases, the collected funds were misappropriated and the investors lost money.

Ethnic and immigrant groups have also been targets of affinity fraud. Financial swindlers see new immigrants as ripe for the picking. Immigrant groups are particularly vulnerable to fraud because they are sometimes isolated from the larger community and their flow of information may be limited because of language and other barriers. Some members of immigrant and other long-established minority groups have accumulated savings and achieved a certain standard of living through years of hard work. Often, they want to “give back” to the community in order to help others like themselves. However, such inclinations often make these group members perfect targets for deceitful con-artists who, despite sharing the same ethnicity or culture, are really motivated by greed.

The rising number of affinity fraud cases in the recent past has prompted state regulators to intensify their efforts in reaching out to ethnic and religious communities and encouraging investors to investigate before they invest in any investment.

B. Attempted Solutions

1. *Enforcement* - Although affinity fraud is not a new concept, in the past two years, state securities regulators have enhanced their investigative and enforcement efforts to combat this type of fraud. In addition to pursuing administrative actions, regulators have, in conjunction with other authorities, also filed civil and criminal complaints against individuals perpetrating affinity fraud.

Although statistics are not available as to the total number of cases and dollar amounts involved, a number of significant cases were pursued in the past year. Several states had cases involving over \$1 million in fraud related to specific religious and ethnic groups. A number of the perpetrators received jail sentences, among them an Alabama con-artist that received a 30-year sentence for bilking 30 retirement age investors out of nearly \$6 million.

2. *Education and Prevention* - State regulators have enhanced their investor education efforts to provide investors with information that will arm them against investment fraud. In addition to providing investors with written materials warning of investment fraud, states have also produced video tapes and public service radio and television announcements that encourage investors to contact their local regulator for information and assistance. Numerous states have also simplified the process for filing complaints. This includes accepting in writing, over the telephone and through the Internet.

Every effort has also been made to publicize investment fraud and the accompanying civil and criminal actions. Investors who hesitate to complain will often come forward only after seeing a report in the media regarding their particular situation. By pursuing criminal actions and obtaining jail sentences that are publicized, states are reaching a number of investors who would otherwise be unaware of the securities laws and various investment frauds.

C. Lessons Learned and Implemented

Although affinity fraud is not a new type of fraud, it is a type of fraud that has recently affected a much broader section of the general public. In the past, affinity fraud complaints tended to involve small, local religious denominations. Regulators are now seeing that perpetrators of religious affinity fraud are operating on a national level. These con-artists are involved in a national organization that contacts local religious leaders and enlists these leaders to solicit funds from their congregations. Members of the congregation trust their local leaders and willingly invest through them.

Similarly, affinity fraud has involved a number of ethnic groups that were previously unaffected by investment fraud. Traditionally, immigrants placed their funds in savings accounts, bonds, and other relatively safe investments. Today, both the old and new immigrants are interested in alternative investments that offer higher rates of return. However, many of these immigrants hesitate to venture outside their community to investigate investment opportunities. They are likely to invest with someone they know or who speaks their language. The investors communicate freely with the con-artists, look up to them, and fail to do any investigative work before giving up what often amounts to their entire savings.

State regulators are utilizing public service announcements and contacts with various community leaders to spread the word about affinity fraud. A greater effort is being made to publicize warnings in the ethnic newspapers and public service announcements.

D. Existing Inter-Agency Cooperation

There has been significant cooperation and information sharing among the various state securities regulators as well as other government agencies. In the past year, a number of states have shared information regarding the affinity frauds that are under investigation. In certain cases, one state assumes the leading role of coordinating information and court filings, thereby, minimizing duplicative efforts. Many cases involving affinity fraud were referred for criminal prosecution and states have successfully worked with prosecutors in obtaining convictions.

E. Improved Coordination in the Future

In the future, it would be beneficial to establish communication with and to obtain assistance from local law enforcement agencies. Many state securities departments are located in the downtown areas of major cities. Victims of affinity fraud, particularly immigrants, are more likely to go to their local police department with a complaint than to seek out the securities department office. The local police departments should be made aware of current trends in fraud and should be encouraged to refer complaints and victims to the securities department or a prosecutor.

F. Additional Suggestions

Affinity fraud involving certain ethnic groups is difficult to investigate and prosecute due to language barriers. A database of government securities regulators and prosecutors who either have special experience with a certain type of fraud or are proficient in a foreign language would be of assistance to regulators.

BUSINESS OPPORTUNITY (FRANCHISE) FRAUD

A. The Problem

Each year, thousands of people fall victim to bogus business opportunities that lure investors with promises of financial independence. Many victims of business opportunity fraud are elderly, work at home mothers, or displaced workers due to corporate downsizing. Business opportunity scam artists typically locate victims through trade shows, newspaper classified advertising, telephone solicitation and, increasingly, the Internet. Typical business opportunities include investments in vending machines, pay telephones, display racks of toys, games or greeting cards, and medical billing software. Investors in business opportunities are promised goods or services and typically marketing assistance, training or locations to enable the novice entrepreneur to operate a business.

Sellers of business opportunities may promise the buyer a guaranteed income and an exclusive territory. In many cases, the seller represents that its business opportunity is offered for only a limited time, pressuring investors to make a quick decision to purchase. The seller even may provide prospective investors with names and telephone numbers of current owners of its business opportunity, who purport to act as references. All too often, however, victims of business opportunity fraud discover that promised marketing assistance or training is useless, equipment or software does not work, supposedly profitable leads or locations do not materialize, and guarantees are worthless. Victims also may discover that the references they contacted are “shills” whom the seller has paid to tell victims a phony success story.

Twenty-three states and the Federal Trade Commission have specific business opportunity laws. States that regulate business opportunities are members of NASAA. Most of these laws require that sellers provide investors with a disclosure document before buying a business opportunity. Many states also require that sellers register with a state agency before the seller may lawfully offer and sell business opportunities in those states. Some state laws require that the seller file a surety bond before offering its business opportunity in the state.

B. Attempted Solutions

States and the Federal Trade Commission have brought numerous enforcement actions against fraudulent business opportunity sellers in 1998-99. Some of the most effective of the state actions were part of joint federal state projects focusing on both law enforcement actions and consumer education. For example, in September 1998, law enforcement officials from 10 states and the Federal Trade Commission teamed up to announce "Operation Vend Up Broke." This initiative resulted in a total of 36 enforcement actions against promoters of bogus vending machine business opportunities. The initiative also resulted in heightened consumer awareness of bogus business opportunities from press coverage of the project and the distribution of new consumer information.

Each year, NASAA conducts a franchise and business opportunity-training seminar for its member states. State regulators and law enforcement officials meet to discuss issues related to franchises and business opportunities. Since 1997, the state training seminar has been held in conjunction with a Federal Trade Commission conference about franchises and business opportunities. These conferences provide valuable information to law enforcement personnel from around the U.S. who share information about common problems and potential solutions to the ongoing problem of business opportunity fraud.

Some states have placed "notices to consumers" in the business opportunity sections of newspaper classified advertisements—the same media used by many business opportunity scam artists. The consumer notices alert the reader about the potential for business opportunity fraud and direct the reader to state agencies for more information or to check out a specific business opportunity. For example, the Maryland Securities Division has placed a consumer notice in the business opportunity classified advertising section of the Baltimore Sun newspaper for several years. The Baltimore Sun provides the advertising space without charge to the state. Over the years, the Maryland Securities Division has answered numerous inquiries from consumers about specific business opportunities, the requirements of state law, and how to avoid being scammed. The Maryland notice, and similar notices placed by other states, have proven to be a valuable tool to prevent the spread of business opportunity fraud.

C. Lessons Learned and Implemented

A variety of state agencies and law enforcement personnel handle issues related to business opportunities. Based on the experience of those states, the following lessons have been learned:

- *Consumer Education.* Perhaps the most effective tool against business opportunity fraud is consumer awareness. The number of fraudulent business promoters is large and ever expanding. Many fraudulent promoters teach others how to perpetrate business opportunity fraud. Law enforcement actions may target specific companies and individuals, but there appears to be a never-ending supply

of fraudulent promoters to take the place of those who came before them. Consumer education, on the other hand, is an effective mechanism to prevent fraudulent business opportunity promoters. Consumer awareness also reduces the pool of potential new victims who are susceptible to business opportunity scams. A consumer with a minimum of information about business opportunity fraud can avoid most of these scam artists, who often use the same fraudulent sales methods to lure victims.

- *Cooperation.* Many fraudulent business opportunity sellers offer their investment to residents outside of their home state. Other sellers move from one state to another to avoid prosecution. Typically, states can take the most effective enforcement actions against sellers that are located within their borders. The states have found that they are most effective in pursuing actions against business opportunity fraud when they can share resources with other state or federal authorities. It is important for states to continue to find ways of sharing information and resources to target this type of fraud. The NASAA sponsored training sessions and conferences have allowed state law enforcement personnel to develop networks with other law enforcement personnel to share information and investigative resources.

D. Existing Interagency Cooperation

As discussed above, state law enforcement personnel have benefited from their ability to meet on a regular basis and share resources. States also have worked—and continue to work—with the Federal Trade Commission on a number of multi jurisdictional law enforcement actions and initiatives. These initiatives generate publicity about the problem of business opportunity fraud, thereby serving a consumer awareness function. States also have access to a database of consumer fraud complaints maintained by the Federal Trade Commission and the National Association of Attorneys General. This database, called the Consumer Sentinel, is a valuable resource about business opportunity fraud in the U.S. and Canada.

E. Improved Coordination in the Future

- *Focus on Business Opportunities As Investments Distinct From Franchises.* In the past, NASAA sponsored training programs and Federal Trade Commission conferences discussing business opportunity fraud have been combined with programs related to franchise issues. The current Federal Trade Commission law related to this area makes no distinction between business opportunities and franchises.⁴ Business opportunities share some similarities to franchises, but the problems related to business opportunities, and the possible solutions to business opportunity fraud, are unique. The state law enforcement agencies that handle matters related to business opportunities are varied: they may be part of a states’

⁴ The Federal Trade Commission has published a Notice of Proposed Rulemaking regarding its Franchise Rule, 16 C.F.R. Part 436, that recommends promulgating a separate rule specifically directed to business opportunities.

consumer protection division, securities division, attorney general's office, or elsewhere. These agencies may or may not also handle issues related to franchises. These law enforcement agencies should consider holding more multi jurisdictional programs or summits in which business opportunities are the sole focus of discussion.

- *Pursue More Criminal Prosecutions.* States and the Federal Trade Commission have taken effective action against promoters of business opportunity fraud. Most of these actions have been civil in nature. In all too many cases, however, promoters of business opportunity fraud often are repeat offenders who submit to civil penalties—or ignore them—only to start a new scam all over again. These promoters should be prosecuted criminally. Law enforcement agencies should seek new methods of cooperation with local, state and national criminal authorities to assist in the criminal prosecution of business opportunity swindlers.

F. Additional Suggestions

The Federal Trade Commission is currently considering a new Rule related to business opportunities. By this rulemaking process, the Federal Trade Commission should consider new and perhaps untried approaches to combat business opportunity fraud.

Existing law enforcement agencies that handle business opportunity issues should seek to find new ways to encourage criminal prosecution of business opportunity scam artists. The law enforcement agencies that regulate and enforce business opportunity laws should consider holding a training program for other law enforcement agencies, including criminal authorities, to educate them about the problems of business opportunity fraud, existing laws and possible investigations.

CONCLUSION

NASAA and its members are proud of the collaborative efforts we have participated in with our federal counterparts. We feel confident that our submission to the Attorney General accurately reflects our commitment and the resources we have dedicated to combating the consumer fraud in the securities industry.

NASAA appreciates the opportunity, presently, as well as in the future, to provide guidance and comments in addressing this area of great concern and importance. If I can be of further assistance, please contact me directly at (317) 232-6690. Thank You.

Sincerely,

Bradley W. Skolnik
President
Indiana Securities Commissioner